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Pension Protection Fund's consultation on new levy framework

14th October 2011

In September, we noted[1] the Pension Protection Fund ("PPF") publication of its consultation on proposed new rules for the levy framework. This followed their earlier consultation on the underlying methodology and the PPF has taken the opportunity to summarise industry feedback and their responses in their latest document.

We are happy to provide clients with further assistance in this area. **The PPF consultation period runs until 2nd November 2011 and so it is important that trustees work swiftly with advisers should they wish to submit comments**.

New Features

One important feature of the new framework is that the funding level of individual schemes, both under current and stressed conditions, is being given proportionately more weighting in the calculation of the levy and the PPF introduction of investment risk stress testing in supporting this is most welcome.

The PPF is implementing a standardised approach for stress testing via the inputs already provided to the Exchange data system, though schemes with protected liabilities in excess of £1.5bn will be required to carry out their own bespoke calculations – this option will also be open

[1] http://www.veaseyassociates.co.uk/2011/09/pension-protection-fund-announces-550m-levy-estimate-consults-3-year-levy-rules/

to all schemes to adopt on a voluntary basis and any who have made signficant progress in asset-liability management and, in particular, LDI strategies should at least consider this.

The bespoke approach is reasonably straightforward to apply and sufficiently flexible to permit schemes with alternative investment strategies to integrate these with the help of their investment adviser / managers.

Other key considerations include the following:

- The PPF is looking to fix the levy rules and parameters for three year periods from 2012. This should have the effect of stabilising individual levy payments as long as scheme-specific parameters (level of liabilities, funding level, investment risk and employer risk) do not significantly change;

- The existing employer risk estimation system will be shrunk from 100 to 10 insolvency bands and levy rates will be drawn from the broad bands rather than from the individual score. It is worth noting that the transitions between bands are rather more abrupt than we are used to so this could lead to discontinuities in assessed levies – though a one year smoothing system has been introduced which will mitigate this for temporary shifts;

- When certifying or recertifying group guarantees, trustees will be formally required to certify that the guarantor could be expected to meet their commitment if called upon to do so at that time. The scope of permissible guarantors has been widened somewhat to include some unassociated companies, but the levy calculation still works on the basis of credit substitution rather than capturing any doubled-up or “best-of” benefit from having multiple sources of underpinning.

Levy calculation

The PPF Board have determined that 89% of the 2012/13 levy is to be raised by a risk-based methodology, with just 11% being based on a simple percentage levy on scheme liabilities. This latter percentage is significantly reduced from prior determinations with the result that the risk-based proportion is well above the 80% minimum level targeted.

The percentage levy on scheme liabilities consists of a simple multiplication through of a fixed parameter times the protected (i.e. s179) liabilities – these to be smoothed on a five year historic basis. This amount obviously scales with scheme size, but is not difficult to calculate and so we will not dwell on it further.

The risk-based levy is calculated by multiplying the higher of scheme current or stressed underfunding by the employer insolvency rate as described above. As the PPF has indicated that the calculation of stressed underfunding is going to be consistent between the standard and bespoke approaches, we now consider the process for the latter.

Bespoke calculation and stress testing

The aim of this process is to model not only the potential current exposure that a scheme presents – i.e. based on current funding deficit – but the extent to which that exposure might worsen during a potential period of sale of illiquid assets and/or de-risking should the scheme need to move into the Fund.

To this end, stress testing is employed to estimate the possible change in scheme assets under an adverse market scenario. This approach is similar in philosophy to the Basel 2 modelling undertaken by banks to estimate market risk impact on their balance sheets and to the approach more recently taken in stress testing the balance sheets of European banks earlier in 2011[2]. This was also adopted for European insurance companies as part of the Solvency 2 initiative and there are current concerns that any naïve future extension of this legislation to cover defined benefit pension schemes could cause significant funding strains[3].

Stress testing is carried out using the same accounting year end data to be submitted as part of the annual scheme return and simply involves a series of percentage haircuts (for growth assets) and increases (for liability matching assets) to be applied. For instance, as the haircut proposed for UK quoted equities is -22%, the stressed value of a current £100m portfolio would simply be £78m. Similarly, as the proposed increase in value for long maturity fixed interest government bonds is +10%, the stressed value of a current £100m portfolio would be £110m.

The process consists of running through the various asset positions, mapping each into the correct category and combining the results. The PPF will then take the lower of the current and stressed asset values for use in the levy calculation.

The most difficult part is the incorporation of derivatives positions, whether held as synthetic assets, hedges or for liability risk reduction, and it is schemes with significant positions for the latter purpose that are most likely to benefit from carrying out the bespoke calculation.

Derivative products are unique because their risk exposure is not directly coupled to their economic exposure; in other words, their change in value due to market factors is not linked to

[2] The subsequent apparent difficulties with the results of the European bank stress tests was not, in our opinion, due to shortcomings in the principle of using these tests but that those adopted were insufficiently rigorous in not including the possibility of sovereign default.

[3] Our research note currently in production

their current market value. For instance, an interest rate swap has no intrinsic value when transacted and yet can subsequently gain or lose value rather rapidly due to market movements.

The benefit for schemes with extensive LDI positions is that these products substantially mimic economic holdings in conventional and/or index-linked gilts, which have a strongly offsetting treatment under the stress test against growth assets in general and equities in particular. Schemes may well already have the appropriate information reported from their LDI manager and, if not, this ought to be easily provided whether for pooled or segregated accounts.

Most schemes will want the calculations to be prepared by their investment consultant although larger schemes with in-house teams will be able to do this themselves as the PPF guidance helpfully provides a number of worked examples for different exposure types.

No adjustment is made for smoothing of either asset or liability values in the bespoke process; this is to be carried out by the PPF as part of the levy calculation once figures are submitted via Exchange.

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